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BEST FINANCIAL PRACTICES LEAD FINANCIAL PERFORMANCE OF SMES

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ABSTRACT

Purpose: The purpose of this research effort is to understand various effects of financial management practices on small firm performance.

Design/Methodology/Approach: A questionnaire-based field survey was conducted to collect data from 103 owner/managers from a random sample of SMEs located in the 4 cities of Punjab state of India. The multiple correlation and regression statistical test were used to analyze the derived 5 hypotheses in conjunction with SPSS 16 software to evaluate the findings.

Findings: This research finds detailed consequence of financial management practices on firm performance which mediate via financial planning capabilities. It covers 4 aspects mainly include, financial forecasting & budgetary planning capabilities, working capital planning capabilities, inventory management capability, financial reporting & financial analysis capabilities. Simply study emphasis from beginning to end of all applied financial management practices effects on small firm financial performance. It has tried to understand capital structure issues via financial forecasting and its later outcomes on liquidity management. Study also indicates to trace why working capital issues occur at small firms? Study shows to assess comparative analysis of inventory management issues and financial reporting practices on financial performance of small firms.

Research Limitations/Implications: This quantitative study is exploring an analysis of small firms and suggests antecedents to understand the impact of financial management practices on financial performance. Used variables have been selected as per best available sources of literature and based on researcher's knowledge. Further study is also required that identifies the other critical areas to evaluate the different effects. Here limitations of practicality and opportunism in the sampling also acknowledged.

Practical Implication: Certainly findings of the study indicate to undertake more research efforts to justify the effects of financial planning capabilities on financial performance of small firm which also leads their failure at a later stage.

Originality/Value*:* Present paper contributes to the understanding how financial performance of small firm often faces issues which are gape of application financial management practices. A combination of few selected capabilities which is designated as financial planning capabilities in the study are essentially to implement for getting the sound financial performance.

KEYWORDS: Financing Performance, Financial Planning Capabilities, Small Firm, Working Capital, Inventory Management, Financial Forecasting, Financial Reporting

INTRODUCTION

Firm financial performance is a chronic research theme studied by academicians, researchers, and practitioners equally. The highly uncertain and changing environment, the ever growing competition among firms, the highly demanding customers, the pressurizing suppliers, the call for continuous improvements and the need for integrating information technologies in every business, force business houses into a daily struggle for survival. These difficulties are more rigorous for small and medium ventures as their resources are less than those of large firms. In spite of these difficulties, some small firms do emerge as winners and create a sustainable competitive advantage after getting the profitability. If the dynamics are similar and equally challenging for all business ventures, what factors account for the success of some firms?

This study tries to identify efficient financial management practices and strategies for small firms which allow them to achieve better financial performance. There is still a paucity of research on small firm strategies and competitiveness particular for accounting practices. Small firms can be innovative, risk taking, proactive or aggressive, depending on the intensity of entrepreneurial orientation. These orientations of management can largely determine the firm performance and business efficiency. This research intends to contribute new ideas and validate the existing body of knowledge about financial management strategies and performance in Indian context.

Financial Management Practices & Financial Performance

Financial management basically deals with money circulation and control of money for all kinds of business operations. (Lasher, 2010). According to Meredith (1986) financial management practices are the central activities for the success of small business. SMEs financial profitability is the conceived result of financial management practices (Dess, et al 1997).

Financial management transactions cover various objectives start with cost calculation, cost control, sales & profit maximization, attaining the market share and overall endurance of firm. (Jacobs, 2001). The arrangements and optimal utilization of financial resources for current and future opportunities provides to organization by financial management practices (Byoun, 2007). The feature of optimum capital structure practices as function of financial management practices provides efficient way and quick cost effective decisions. (Temtime & Pansiri, 2007). Emerging economies get the advantage of financial flexibility which helps in the various economic cycles (Graham & Harvey 2001; Bancel & Mittoo, 2004).

Financial management practices cover all implications of finances to various activities includes, production, investment, personnel and marketing decision particular to calculate overall financial performance (Meredith 1986). Simply financial management practices cover a broad aspect to understand future financial performance with a way to maximize the profit and conversion into wealth and typically it works to capitalize the efficiency of financial resources.

McMahon (1993, p.3) defines “financial management based on mobilizing and using sources of funds: it is concerned with raising the funds needed to finance the enterprise’s assets and activities, the allocation of theses scare funds between competing uses, and with ensuring that the funds are used effectively and efficiently in achieving the enterprise’s goal”. SMEs are rare to effective use of risk management, liquidity, working capital, scientific inventory management, project valuation thorough capital budgeting techniques, financial reporting and financial analysis which are core functioning areas of financial management practices and this issue is the most critical aspect for obtaining the best financial

results (Terpstra and Olson 1993).

Small business have been using the different set of financial management practices, core principals of financial management practices are not exercised, it run with short term financial management approach and run by the personal business goals of the owner (Jarvis, et al 1996), (Collis & Jarvis, 2002).

Collis and Jarvis (2002) stated that at SMEs the function of financial management practices is concerned only with cash based information, particular for effective use of financial resources and control of allocation of funds and generally for the same formal accounting system is not being in the practice, it goes with the expertise of external resources (Jarvis, et al 1996). Collis and Jarvis (2002) revealed that to overcome the various constraints, hindrances of capacity utilization, small business must put consternation for computerized accounting for effective uses of financial management practices.

As a conclusion of various studies, author feels the lack of adoption of financial management practices by SMEs may be justified in the below described areas:

- Absence of understanding effective interpretation of financial management information and uses of financial statements.
- Driven by the owner's financial management goal and which is not led by financial management practices.
- Lack of expertise for recognizes the effective utilization of financial management practices for attaining the financial profitability.
- Reliance on external expertise to capitalize the financial management practices to obtain effective uses of financial resources.

Every firm's financial performance shows the financial health and it is an indicator of a firm's financial soundness and profitability. Financial performance can be estimated or calculated with various tolls but each measure draws or portrays the different aspect of financial performance. Codjia (2010), actually financial performance is an analysis of financial statement which include the account summary based on fixed tenure the desire of daily, monthly, quarterly, yearly and it pertains revenues, expenses, profit / loss, changes into assets and liabilities. The failure of SMEs are general happen due to not effective use of finance & estimation of financial performance Small business only concerns with the case based information from accounting system, but estimation of cash inflows and cash outflows are not in properly excise, as it requires accurate cash flow statement, and as a result they receive less profit or suffers with the losses (Mbonyane, 2006). and therefore financial management practices are the biggest challenges for the small business (Mosalakae, 2007).

SMEs Perspective and Trend of Financial Practices

Wiltshire (1971) defines a small business as: "A business in which one or two people are required to make all the critical decisions (such as finance, accounting, personnel, purchasing, processing or servicing, marketing, selling) without the aid of internal specialists and with specific knowledge in only one or two functional areas". Small and Medium Enterprises (SMEs) contribute significantly particular in inclusive growth of economy (Peters and Waterman, 1982; Amini, 2004; Radam et al., 2008).

It is well known for promoting equitable development in particular developing and emerging countries. It is the nursery for entrepreneurship, often driven by the individual creativity and innovation, with a significant contribution in the country's GDP manufacturing output, exports & employment generation and greater prosperity for the nation. Small business contribute in various ways to the GDP of economies include innovation, employment, leadership and exports; somehow it births the innovation at start-up level during the time of taking risk which is the basis of growth of industries for next stage specially at emerging economies (Becheikh, et.al. 2006).

The efficient individuality of SMEs is to provide the large scale employability and entrepreneurship through small business practices provides a rational judgmental way of equitable division of national resources & income. In absence of this, resources either can be centralized or not effective utilized, which will certainly results of not achieving the sustainable and inclusive growth.

Largely small business houses are in practices at every economies of the world and they are being known as private players. Japanese economy is majorly fueled with SMEs contribution and the formal business models at South Africa are lead by small business houses. Estimates suggest that "more than 95% of enterprises across the world are SMEs, accounting for approximately 60% of private sector employment." (Ayyagari et al. 2011), (Abor & Quartey 2010).

India is the emerging economy and here also SMEs considerably contribute around 80% of Indian market (Ghatak 2010). Indian MSMEs contribute 8% of GDP, 45% of the manufactured output and 40% in Exports. They also represent over 80% of Industrial Enterprises and have been instrumental in building a solid industrial base in India. Despite their commendable contribution in Indian economy, still SME Sector does not have the competitiveness in the domestic market as well for enhancing the globalization effects and therefore they are like a handicap in becoming more competitive in the National and International Markets. Their contribution to the economy is huge and hence they are entitled to their rightful share of attention from financial institutions.

The major hindrances SMEs generally face are accounting & financial management challenges. For this various issues can be addressed, but majorly the inefficient financial judgment comes due to not effective utilization of accounting information. Essentially they do not approach standardized & formal accounting practices, which provide them the unreliable accounting information, which do not offer the way of authentic & rational financial decision making (Sarapaivanich, 2003). Indeed the formal & proper accounting practices are always useful to evaluate the financial performance of any business. For small business it is essentially required to be followed since risk factor pertains high due to various constraints of capital recourses, as there is no effective capital market for SMEs, only banks are general source of finance.

SMEs failure or difficulties to face the less profitability comes as a result of irrational financial decision in various ways and simply it happens due to inaccurate accounting information which lead inefficient financial management information (Miller and Rojas, 2004).

Financial reporting system provide the way to value effective utilization of financial resources and essentially for SMEs the skills of analysis of financial performance are required to overcome from various issues (McMahon 1999). Management accounting information provides a basis of analysis of financial performance, and simply for small business it depends on the accounting practices what have been in exercise (Holmes and Nicholls 1989).

Various studies across the all economies identified effective financial management practices is as one core

fundamental of SMEs success, but it is also noticed that small business houses usually ignore the formal accounting and financial management structure in the practices and as a result they suffer. Fong (1990) suggested usually Malaysian SMEs are led by the owners with conventional approach, since business management education is missing there and as a result they undergo with poor financial performance. Thus professional accounting system shall be introduced for consistent growth and maximization of wealth at SMEs. A professional financial manager will be able to manage the firm's financial affair effectively and capitalize the resources in a rational way.

Theory and Hypotheses

Financial performance estimation directs by the implementation and application of best financial management practices at SMEs (Zahra & Covin, 1995). Significantly financial management practices contributes towards financial performance at Small business and it has been proved in various research studies specifically at developed countries. But at developing & emerging countries; it is inadequate and an efforts needs to be done, because SMEs contribution play pivotal role in their development (Hashim & Abdullah 2000).

A study of 100 manufacturing SMEs at Malaysia, around 16.1% deficiencies related to performance & application of financial management practices and strong weakness traced through poor working capital management, accounted for 93.6% particular for liquidity management (Hashim and Wafa 2002).

The cause of failure in terms of financial difficulty for small business houses majorly concerned with management accounting application including inefficient working capital availability and shortage of long term funds to meet the operating cost and capital expenditure respectively. But small business houses cannot overcome from these scarcities due to absence of appropriate accounting & financial management practices.

Peacock (1988) accessed that absence of inefficient or purely nonexistence of formal accounting practices leads the small business houses towards financial hitch. Result comes as failure, due to not calculation of taxation payment and interest liabilities to lenders. Broom and Lengenecker (1975), Haswell & Holmes (1989), Bates & Nucci (1989), Watson & Everett (1996) all revealed that the proper accounting & financial management practices are requisite for every type of business; otherwise it result the failure of business. But it is being more evident to realize the failure of small business compare to larger business houses.

Lovett (1980) Investigated and found about absence of formal costing system and entire costing calculation of material, labor and overheads was dependent on rough estimation or accounted with periodic attempts. Similarly sales value and volume along with profit targeting was also calculated. Peacock (1985) explored into his research survey for 1000 firms that 4.6% South Australian small business houses failed, between the years 1975-85 due to no accounting or inadequate financial management practices.

Peacock (1987) found the formal and standardized accounting practices only with 2% industries. Around 50% SMEs used single entry system of financial accounting and 33% used accounting for calculation of taxation and financial cost payment only. These facts had traced during an analysis survey 418 SMEs bankruptcy reports during 4 years ended at the year 1985. Based on this discussion, author propose base hypothesis:

Hypothesis 1: Financial Management Practices are Positively Related to Financial Performance, Mediating Role of Financial Planning Capabilities

It is evident from the previous discussion that despite a large amount of research which has gone into the understanding of financial practices and financial performance, the results remain inconclusive. This is because financial management practices don't impact financial performance directly, but impacts various aspects of organizations which consequently lead to performance & productivity improvements. Substantial & significant facts reveal that SMEs financial management goal moves with owner perspective only therefore it leads short term objectives only.

Financial reporting system does not properly exist and they do less act on accounting information for financial planning (McMahon & Holmes, 1990). The success of every business depends on 3 decision of finance manager who acts and take care of financial planning section of business organization, and it remain the same importance for small business houses too - (1) budgeting decision, (2) financing decision to avail the long term funds, (3) Liquidity management to consider the short-term finances for managing the net working capital (Ross, Westerfield and Jaffe 1999).

Author proposes that financial management practices helps in building various capabilities, which in turn lead to best financial performance. An organization's financial management practices depend on how organization tends to act and how use the financial planning knowledge. Below table summarizes various financial planning capabilities related to financial management practices of any organizations.

Table 1: Aspects of Financial Planning Capabilities

Forecasting & Budgetary Capabilities	Estimation of Funds, Sources of Funds**,** Financial forecasting for cost & revenue.
Working Capital Availability Capabilities	Allocation of funds, Assets mixture & Liquidity decisions (cash receivable management, & payable management)
Inventory Management Capabilities	Arduous relationship of inventory & current assets with liquidity management.
Financial Reporting & Analysis Capabilities	Variance analysis & Pre financial performance analysis

Hypothesis 2: Financial Management Practices – Financial Performance Relationship is Positively Mediated by Financial Forecasting & Budgetary Planning Capabilities

Lack of knowledge of financial management combined with the uncertainty of the business environment often lead SMEs to serious problems regarding financial performances, regardless of whether owner-manager or hired-manager, if the financial decisions are wrong, profitability of the company will be adversely affected. Consequently, SME profitability could be damaged because of inefficient financial management. SMEs have often failed due to lack of knowledge of efficient financial management.

Long term financing sources and capital volume always remain constraints at Small sector and therefore undercapitalization and uncertainty of the business environment cause a major threat to SMEs.

Accordingly excessive dependency on equity and to maintain high liquidity kind of financial characteristics probably affect their profitability (Vuong, 1998).

Hypothesis 3: Financial Management Practices – Financial Performance Relationship is Positively Mediated by Working Capital Availability Capabilities

Efficient working capital management is an essential and critical financial management activity. Adequate working capital requires for smooth operation, inadequate and excessive both are harmful situation for every kind business organizations. For small business, it pertain the major importance as capital availability is always remaining a constraint for them due to less availability of multiple finance sources. According to Meredith (1986) argues about the importance of working capital management as the key function of financial management practices and always the success and even consistent success depends on effective performance of financial management practices thorough working capital management.

Hypothesis 4: Financial Practices – Financial Performance Relationship is Positively Mediated by Inventory Management Capabilities

Inventory holds the major volume of current assets and excessive inventory leads towards ideals funds and short inventory produces less profitability. It takes the scientific wattage particular at prefect and globalised markets for bigger business organization. Ricklavely (1996) stated, capacity utilization, cost reduction and quality are 3 major forces to get the profitable advantage in the competitive environment and for SMEs, it can be realized with inventory management practices & integrated inventory management system.

Maria and Jones (2003) exposed scientific inventory management practices can produce relatively less cost productivity for high quality products. Ballou, (2000) and Palmer and Dean (2000) stated variety of inventory management practice exist, but its comprehensive performance depends on the selection of tight tool. The carrying cost range between 20 to 40% and it can be burdens to small business organization as relatively their revenues are less, but nevertheless it will increase the profitability. Grablowsky (1980) investigated into a survey, 30% excessive capital investment at inventory, only 6% were using the scientific tool likewise EOQ, Re-order point for reduction in the inventory cost or to obtain the optimal inventory level. 54% respondents had no registered data about various inventory level, cost includes in the inventory.

Hence, we propose the following hypothesis:

Hypothesis 5: Financial Practices – Financial Performance Relationship is Positively Mediated by Financial Reporting and Analysis Capabilities

Formal application of accounting & financial practices provide the way of accurate financial reporting and analysis capabilities, which leads towards the way of financial performance of business. Small business houses majorly prepare the financial reporting system but it does not provide the facts for management accounting decision, because the accounting summary only includes the profitability statements.

On the other side no formal accounting data was traced with 19% SMEs during the survey (De Thomas and Fredenberger 1985). Financial reporting is the core stand of accounting and financial management practices and it is only which provides the various bases for evaluation of financial performance which is important to judge the liquidity, profitability and growth of the business organization (Meredith 1986).

METHODS

Data Sources and Sample

This research study is designed to describe characteristics of financial management practices of SMEs to investigate their impact on financial performance of SMEs. Therefore a combination of descriptive and causal research has been opted for this research. In this research survey & secondary data methods are used in combination as research design to investigate and describe financial management practices of SMEs. Questionnaires were designed and directly delivered to SMEs to collect data related to financial management practices and here all items were measured on Likert's 7 point scale.

Data for this study were collected from entrepreneurs located in the industrial belt of 4 cities of Punjab state. A total of 150 questionnaires were distributed across various units in the belt and given a week to fill in their responses. Whenever possible, we explained the importance of the study to the founders and promised to share the collective findings, in case they were interested. After a week, all units were contacted and filled-in questionnaires were collected.

A total of 69 questionnaires were found completed. During pick-up, we requested the remaining set-ups to complete the questionnaire in one more week. We received another 28 filled-in questionnaires in our final visit. 4 questionnaires were incomplete in some aspects and hence couldn't be used, thus resulting in a total of 93 questionnaires and a response rate of 62%.

Instruments

Table 2 provides the correlations among various constructs. As it is clearly evident, financial management practices are strongly & significantly correlated with various financial planning capabilities and with financial performance. Since none of the variables share a correlation of more than .8, there are no major concerns of multi-collinearity. Hence, we proceeded with regression analysis in order to test our proposed hypothesis.

Table 2: Correlation Coefficients

	0FMP	FF&BP C	WCA C	I M C	FR & A C	Performance
FMP	1	.642**	.617**	.507**	.550**	.698**
FF&BP C	.642**	1	.484**	.417**	.321**	.664**
WCA C	.617**	.484**	1	.385**	.442**	.623*
I M C	.507**	.417**	.385**	1	.369**	.570
FR & A C	.550**	.321**	.442**	.369**	1	.516*
FP	.698**	.594**	.269*	.170	.256*	1

** Correlation is significant at .01 level;* Correlation is significant at .05 level
N = 93
** Correlation is significant at .01 level; * Correlation is significant at .05 level
† Standardized regression coefficients are reported.

FINDINGS

Table 3 provides the results of the regression. When we regressed financial management practices on SMEs financial performance, we got significant positive relationship between the two. Thus, our hypothesis 1 was confirmed. However, since financial management practices (FMP) explained only 35% in the total variance of firm performance, it can be expected FMP is a direct contributor of financial performance and mediate by other factors.

In order to test the next 4 hypotheses, we tested for relationship between Financial management practices (FMP)

and various Financial planning capabilities (FPC), namely financial forecasting & budgetary planning capabilities, working capital availability capabilities, financial reporting & analysis capabilities and inventory management capabilities. We found significantly strong relationships between financial management practices and all financial planning capabilities. Thus, our argument that financial management practices assists in building financial planning capabilities in organizations is validated.

However, in order for our proposed hypotheses to be true, it is imperative that the financial planning capabilities also contribute significantly towards SME's financial performance. When we regressed various capabilities on SME financial performance, it was found that financial forecasting & budgetary planning capabilities were strongly impacted SMEs financial performance while working capital availability capabilities and financial reporting & analysis capabilities only partially contributed to firm performance.

Interestingly, Inventory management capabilities didn't relate strongly to SME's financial performance. Since the variance in firm performance explained by financial forecasting & budgetary planning capabilities is much higher (54%) as compared to that explained by financial management practices directly (49%), it can be concluded that financial forecasting & budgetary planning capabilities mediate the relationship between financial management practices and financial performance. Hence, hypothesis 2 is also validated.

Similarly, working capital availability capabilities, financial reporting & analysis capabilities and inventory management capabilities also partially mediate this relationship. Hence, rest all hypotheses 3, 4 and 5 are partially supported because their respective variance was 44%, 4.6% and 11.3%.

Table 3: Linear Regression Outputs

Relationship	Coefficient †	Adj R-Square	Model F
FMP – FP	.698**	.489	13.9**
FMP – FF&BP Capabilities	.642**	.404	51.79**
FMP – WCA Capabilities	.617**	.372	45.4**
FMP – I M Capabilities	.507**	.247	25.6**
FMP – FR & A Capabilities	.550**	.293	32.09**
FF&BP Capabilities – FP	.664**	.544	40.37**
WCA Capabilities – FP	.623*	.44	25.77*
I M Capabilities – FP	.570	.046	2.19
FR & A Capabilities - FP	.516*	.113	15.2*

DISCUSSIONS AND CONCLUSIONS

This study provided several insights on the relationship between financial management practices and SMEs financial performance. Here author argued that this relationship is mediated by various financial planning capabilities not straight forward. The research attempt has proposed several hypothesis concerning financial forecasting & budgetary planning, working capital availability, financial reporting and analysis, inventory management capabilities, and all were empirically validated the same.

One reason why financial forecasting & budgetary planning capabilities contributed most to the financial performance because of pre-hand estimation of required funds, revenue and cost and it makes it one of the most crucial aspects of financial performance. While working capital availability, financial reporting & analysis capabilities also contributed significantly as expected, but the slight contribution of inventory management capabilities is beyond belief.

This could be significant research finding or an error attributable to scale or measurement. While this is the first attempt to bring in financial planning capabilities in the financial management practices literature, further investigation is vital to carry in more clarity to explore these relationships.

This research can be extended in multiple directions. Firstly, we only captured four dimensions of financial performance, but there are many more. Additionally, we couldn't capture the linkages of various sub-dimensions of financial management practices with different financial planning capabilities. A deeper analysis might provide indications on what dimensions of financial management are more relevant for building different financial planning capabilities.

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